FEDERAL TAXATION OF INCOME AND PROFITS

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Now that the war is over, our attitude with respect to tax legislation is different from that which we occupied when, in the midst of the conflict, the taxes were enacted which are now to be revised. At that time the supreme consideration was to obtain revenue, large revenue and without delay. Administrative efficiency was of prime importance; questions of justice had to take second place. And right here I feel impelled to testify to the skill and good judgment generally shown in the framing of our war tax legislation. The end to be accomplished was accomplished, and, on the whole, with a reasonable approach to equity.

Today our position is different. The task is to criticize and overhaul war taxation, and to put the revenue system on a peace basis of relative permanency. The crisis is past. There is not the need for hurried action. The present revenue is large and, while the government's needs are also large, there is at least no necessity for any sudden increase of revenue. Whatever is done now should therefore be done carefully and deliberately, with the purpose of putting the federal taxes upon such basis of sound principle as is demanded of a permanent revenue system.

If this is our aim, the first step, I believe, is to get down to fundamental principles regarding the taxation of income. For a generation and more the personal income tax has been the backbone of Europe's revenue systems. In the development of income taxation, the United States has lagged behind the rest of the world. Heretofore the reliance of the federal government upon indirect taxation and of the states and municipalities upon property taxes has diverted our attention from the taxation of incomes. We are today just on the threshold of the development of the income tax as the foundation of our revenue system. It is a time when we should guard our steps, in order to avoid mistakes whose effects may be fundamental and far-reaching. Our use of indirect taxes has not been too successful, and our experience with the property tax has been a dismal and notorious failure. We have already made some false steps in the application of the income tax. Let us beware lest ill-considered action at the present time endanger the success of the tax which is without doubt destined to be the center of the American tax system.

I think I need not further emphasize the present necessity of a careful analysis of the nature of income and of its relation to taxation as the first step in tax revision. Practical legislation and administration may not always be able to carry out sound principle in every detail, yet even

in such cases trouble is avoided if there is at least recognition of the discrepancy between principle and practice.

What is income? In my opinion the most satisfactory definition is—the services rendered by capital and by human beings. This definition I think best expresses the nature of income for the purpose of economic analysis. It also agrees as closely as any definition can with the popular understanding of the term. On carrying this concept of income over into the practical field of taxation, I shall not forget that no scientific definition can be followed slavishly in all its practical applications. Administrative considerations will of necessity require departures from the exact scientific principle, but such variations ought to be made intelligently and with the basic principle never lost sight of.

An important exception of this sort confronts us at once in connection with income taxation. In the modern field of business, money income is the prominent thing. To the business man, income ordinarily signifies receipt of money, and it is not surprising that tax legislation has pretty generally thus limited the idea of income. Now it is certain that in any real economic analysis income cannot be restricted to the receipt of money. By no means all of the services of capital and persons are rendered to the recipient in the form of money received. The houseowner who lives in his own house enjoys an income from it no less real and no less in amount than the income received by the owner of a similar house which is rented to a tenant. The money receipts of a farmer furnish a most imperfect account of his real income. Tax legislation generally fails to recognize income which does not appear in the form of money receipts. There have been exceptions. The Wisconsin income tax, for example, undertook to include the rental value of a house occupied by the owner as income. The Civil War income tax recognized the essentially similar positions of the occupier of a rented house and the occupier of his own dwelling, but undertook to secure equality by permitting the deduction of the annual rental value by both. In neither case can it be considered that the result was a success, and the Wisconsin Tax Commission has definitely announced its belief that the attempt was not worth while. Indeed the attempt to include in taxable income services which do not appear as money receipts involves so many uncertainties and such great administrative difficulties that the lawmaker is probably justified in declining as a rule to consider any but money income. Actually most income is today in the form of money receipts. It must not be forgotten, however, that such limitation does involve departure from scientific principle and, as a result, causes discrimination in favor of certain classes, particularly the farmers, who are in effect permitted to deduct living and family expenses from taxable income, a deduction expressly forbidden to all those

whose family and living expenses must be met by money payments. Similarly the citizen who lives in his own house is favored with an allowance for house rent expressly denied to those who pay rent. The time may come, particularly in connection with the extension of state income taxes, when it may be possible to broaden the definition of income so as to take account of these discrepancies. In the present discussion of the federal income tax, however, I think we are justified in adhering practically to money income.

A more important and more troublesome problem is that of applying practically the distinction between income and capital. Income is a service rendered by capital. Increase in the amount or value of capital itself is not income. The distinction between capital and income is not a particularly difficult one in theory. The problems arising from its practical application, on the other hand, are complex in the extreme, and the United States income tax has not succeeded in applying the distinction with any great degree of logic or even of practical success.

On the one hand the distinction is clearly recognized in that gifts and inheritances are regarded not as income, but as an acquisition of or an addition to capital. The law expressly recognizes that these additions to capital will themselves in turn yield income which will later be subject to the tax. The law is here in harmony with economic principle.

But suppose capital is increased, not by sudden additions, but by gradual growth in value. Is this increase income? Certainly not, if I have stated correctly the true character of income. This is a question upon which there has been difference of opinion among economists. The issue was fought out at a previous meeting of this Association under the general topic *Are Savings Income?*[1] I think it is today safe to say that the weight of economic authority supports the theory that mere growth in value of capital is not income. Capital does not render service to its owner by simply growing in size. Presumably it is now capable of yielding a larger service than before, but it is this service which is income, not the increase in the value of the capital. In fact, it is frequently (though not always) this very power to yield larger income which has caused the capital to increase in value.

On the whole, the lawmakers have held fairly well to this principle. If land appreciates in value, the increase is not taxed as income so long as the ownership of the land does not change. If a corporation's assets increase in value or its prospects of future earnings improve, the corresponding rise in the value of its shares is not treated as income to the shareholder so long as the ownership remains the same. This is correct. But the situation changes when capital assets are sold or exchanged. In such event the law regards as income the difference be-

[1] *Publications of the American Economic Association,* vol. IX, No. 1, April, 1908.

tween the value of the article on the date when sold or exchanged and its cost, or, if acquired before March 1, 1913, its value on that date. So long as the owner holds his capital its growth in value is generally not regarded as income, but just as soon as he sells it or exchanges it for other property, he must render an accounting, and show a gain or loss; the gain, if any, is income.

This position is clearly illogical, whatever otherwise may be said for it. If growth of capital value is not income so long as the capital is not disposed of, on what grounds can the increase in value be regarded as income simply because a particular piece of capital is exchanged for another of presumably the same value? The transfer presumably makes no change in the value of the owner's capital. No service is rendered to him by his capital on account of the transfer. To treat growth of capital value as income merely because there is an exchange of capital is inconsistent. That such treatment would be likely in certain cases to lead to great injustice is apparently recognized in the law itself, since an exception is made, applying, however, only to cases where "in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value." In such cases the law prescribes that "no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." Aside from the reference to "par or face value," which is illogical, this clause of the law represents what I regard as the sound principle to apply to all cases of transfer of capital assets. Why should it be limited to reorganization, merger, and consolidation of corporations? The principle is exactly the same in every case where securities are exchanged for other securities or, indeed, where capital assets of any sort are exchanged for other capital assets. No income is derived on account of the transfer. The presumption is that the value given is the same as the value received, and even if a greater value is received, the result is not income but increase of capital. In this case the gain is of the nature of a gift, and gifts are not regarded as income even in the law.

The matter is perhaps not quite so clear in the case of sales of capital assets. Here the thing received is not another article of capital of the same sort, but money. Yet even here I must confess my inability to find any logical justification for regarding the gain from such sale as income. The owner has simply transferred capital of one form into capital in the form of money. It cannot be said that his capital has yet rendered him a service. It is quite possible that the money will immediately be used in the purchase of other capital assets of the same

general character as those sold. In such case, the owner's capital remains of the same value as before, and it has rendered him no service. But, it may be asked, have we not accepted on practical grounds the legal definition of income as practically money receipts? Should we not say that the owner's capital has rendered him service by bringing in money, and that the money so received is the income? Very good: but if so, it is the entire money proceeds of the sale, not merely the gain, which is income. This would be logical, and there is much to be said for such a construction, if accompanied by the right to offset money expended in the purchase of new capital. To be logical we should either regard the sale of property for money as yielding no income at all, or else we must regard the entire proceeds of the sale as income. I can find no logical ground for regarding as income merely that part of the money proceeds which represents a gain over the cost, or the value on a certain date, of the property sold.

By a somewhat remarkable coincidence, this view has just received support from a decision of Judge Thomas in the United States District Court of Connecticut in the case of Brewster vs. Walsh. The case involved this very point, and the decision, rendered on December 16, 1920, holds "that the appreciation in value of . . . bonds, even though realized by sale, is not income taxable as such." The Court concludes that such appreciation is capital, not income, and that a tax imposed upon it is a direct tax and would have to be apportioned among the states according to population. This decision, if sustained, will of course mean a complete reversal of the situation in this respect. Its influence in bringing our income tax law back to sound fundamental principles will, in my opinion, be second only to that of the decisions of the Supreme Court in the stock dividend cases.

Pending final legal determination of this matter, it may perhaps be a waste of time to discuss a possible compromise. I should, however, like to suggest that, in case this decision should be reversed, the exception which the law now grants for exchange of securities in connection with mergers, etc., should be extended at least to all transfers of property except where there is an actual sale for money or for something so nearly equivalent to money that it can be turned into money without another sale; such for instance, as a promissory note or a book credit. This I recognize is illogical and a purely practical compromise. But it has the advantage of removing the most serious cases of injustice, and it would simplify greatly the administration problem.

Of course nothing in the foregoing is intended to interfere with the present practice of determining income of traders and dealers through comparative inventories of stock in trade. There is no reason why this procedure, developed by accounting practice and fairly satisfactory to

all concerned, should not continue. Difficulty would occasionally arise in distinguishing a dealer from one who was not in the business of buying and selling goods or capital assets, but this is a matter which could without doubt be taken care of satisfactorily.

While our attention is on the distinction between capital and income, our old friend, the stock dividend, deserves at least a passing word of recognition. I have elsewhere[2] tried to show that, whatever our theory of growth of capital value, the stock dividend cannot be included in any logical definition of income. It certainly constitutes no service rendered by capital to its owner. It represents nothing given by the corporation to the stockholder. It consists simply in a bookkeeping change in the liability of the corporation to its stockholders; namely, a transfer from surplus to capital. This is not income. But, it may be argued, does not the stock dividend represent a growth in the value of the capital invested in the corporation? Very probably it does, but this growth did not take place suddenly when the stock dividend was paid. The stock dividend did not cause it. It had been going on gradually, for a longer or shorter period, and was shown by the growth in the corporation's surplus. Growth of capital was there already, before the stock dividend was declared, and would have been just as much present if the stock dividend had never been declared. The law must choose one or the other definition. If it chose to define growth of capital as income, it then need pay no attention to the stock dividend, but must periodically ascertain in every case the actual growth in the value of the capital, whether stock dividends have been declared or not. If, on the other hand, the law supports the economic principle that growth of capital is not income, there is no longer even the superficial justification for regarding the stock dividend as income. Fortunately this matter has been definitely settled by decisions of the United States Supreme Court, in a way which agrees I think not only with economic principle, but also with the underlying theory of our income tax law itself.

I recognize that there may be a perfectly reasonable feeling that growth of capital ought to be taxed. But this is an entirely separate question from whether growth of capital should be treated as income. The fact that inheritances are not subject to the income tax does not mean that we cannot tax inheritances. If growth of capital assets is a proper subject for taxation, there should be a separate tax for that purpose. Such taxes have already been developed in various countries: for example, Germany's *Zuwachssteuer*, which before the war had made considerable progress. Of course, the fact is that such a tax would undoubtedly be considered a direct tax in this country and would so run

[2] *Bulletin of the National Tax Association*, April, 1918, p. 161; June 1918, p. 240; April, 1920, p. 208.

counter to the constitutional requirement of apportionment among the states according to population. This is a legal rather than an economic obstacle, and in my opinion does not justify a strained definition of income in order to evade the constitutional limitation upon direct taxation. The proper remedy is a constitutional amendment. States and municipalities of course are subject to no such restriction.

The most fundamental thing about the income tax is its personal character. If this tax is to serve as the foundation of our revenue system, it is essential that it be kept a strictly personal tax. The great advantage of the income tax is that it, more than any other tax, may be relied on to distribute the burden of government among the citizens in proportion to their ability to pay. No other tax does this so well. But this result can be achieved only so long as the personal character of the income tax is maintained. The practical problem for us here is the relation between the individual income tax and the taxes upon corporations. In the early days of American taxation, when the corporation was just coming into prominence, it was assumed that corporations should be taxed exactly like natural persons, under the same laws and in the same manner. Corporations were simply so many additional persons, to be taxed under existing laws. In the course of time, and a longer time than now seems reasonable, it was discovered that taxing corporations by the same methods as individuals and in addition to individuals was leading to unjust double taxation. The corporation paid taxes on all its property. The stockholder was taxed on his shares. Gradually the injustice of this was realized, and the next step was to tax the corporation, not in addition to, but in lieu of, the individuals who owned its shares. This arrangement had the appearance of justice and simplicity. Instead of taxing each individual shareholder on the value of his shares (representing ownership in the corporation's assets), why not tax the corporation once for all on all its property and exempt its shares in the hands of the stockholders? This was, indeed, a real forward step in the administration of the general property tax. There were, it is true, interstate complications, and the matter of bonds and notes was never satisfactorily cared for. But double taxation was avoided, or at any rate reduced, and a long stride toward administrative certainty was taken.

This experience with the general property tax, reinforced by the example of Great Britain's long and successful use of the principle of stoppage at the source, has doubtless been responsible for the notion that the same relation between the corporation and the individual could be carried over into the income tax. But this is a mistake. The only kind of income tax to which this arrangement could be successfully applied is one in which there is neither personal exemption nor progressive

rates. This is a topic which I have already discussed in an article just published in the AMERICAN ECONOMIC REVIEW for December.[3] Desiring to avoid vain repetitions, let me simply state that in that article I have undertaken to show that under an income tax having personal exemptions and progressive rates (like our own and practically every other modern income tax), it is impossible to tax corporate incomes in lieu of the tax upon the incomes of their shareholders, without doing serious injustice to many stockholders. Yet to a very considerable extent this is exactly what our law does. Corporations pay a 10 per cent tax upon their net income (less excess profits taxes and other credits). Stockholders are not taxed upon dividends so far as the normal tax is concerned.

The result is (1) that many stockholders are taxed, through the corporation, upon income which, on account of the personal exemptions and credits for dependents, would be tax-free if the tax were imposed upon the recipients of dividends instead of upon corporate income; and (2) much income is taxed, through the corporation, at the rate of 10 per cent, which, if taxed to the individuals in the form of dividends, would pay only the lower normal rate of 4 per cent. This is a violation of the spirit of the income tax law. It is not excused, but made more flagrant, by the fact that it does not affect all stockholders. Many stockholders have incomes from sources other than dividends sufficient to allow them the advantage of their statutory credits and of the lower normal rate on the next $4000 of net income. To such persons the law works no hardship. These are the wealthy and the well-to-do. But to those whose other income is not so great there is denied the advantage of the credits and the low normal rate to which the spirit of the law entitles them. These are the widows and orphans, the aged, and those on the lower rungs of the economic ladder.

Since the publication of the article referred to, I have tried to make some estimate of the extent of this injustice. First, as to denial of the personal exemptions and credits for dependents. Every person who receives any income in the form of dividends, and who does not receive net income from other sources equal to the total credits for personal exemption and for dependents to which he is entitled, is denied the benefit of the whole or a part of such credits.

There is no way of calculating the amount of the injustice thus done through the denial of statutory credits. Every taxpayer is entitled to at least a personal exemption of $1000 or $2000, but there is no information available to correlate the receipt of dividends with the amount of income from other sources to which the exemptions may be applied.

However, the statistics published by the Commissioner of Internal

[3] AMERICAN ECONOMIC REVIEW, Dec., 1920, pp. 785-99.

Revenue show that, in the year 1918, a million and a half people having income of $1000-$2000 received $46,000,000 in dividends. Another million and a half, with incomes of $2000-$3000 received $88,000,000 in dividends, while nearly a million others having incomes of $3000-$5000 received $202,000,000 in dividends. It is certain that not all of these persons had income from other sources out of which to take their credits, and that some considerable part of these $336,000,000 of dividends should not have borne a tax. Just how much should have been exempt it is not possible to say.

As to the injustice done through denial of the 4 per cent normal rate, a more satisfactory calculation can be made. Every taxpayer is entitled to the 4 per cent normal rate upon such part of his net income in excess of his credits for personal exemption and dependents and for dividends as does not exceed $4000. The spirit of the law is that the first $4000 of taxable net income (*i.e.*, above the credits for personal exemption and dependents) should be taxed at the 4 per cent normal rate. Dividends are assumed to have already borne their share on account of the 10 per cent tax paid by the corporation upon its net income. If, in lieu of the corporation income tax, dividends were included in the taxable incomes of individuals (for normal tax as well as surtaxes), the 4 per cent normal rate would naturally apply to the first $4000 of net income above the credits for personal exemption and dependents. Today every person who receives any income in the form of dividends, and whose net income from other sources does not exceed his credits for personal exemption and dependents by at least $4000 is denied the benefit, in whole or in part, of the low normal rate on the first $4000 of taxable net income.

The statistics published by the Commissioner of Internal Revenue show the number of taxpayers making returns of incomes from $1000 to $5000. Now since each of these persons was entitled to at least the personal exemption of $1000, none of these persons could have had taxable income of more than $4000, and it is obvious that, under the spirit of the law the entire taxable income of these persons should have paid only the 4 per cent normal rate. These persons, in the year 1918, received in dividends $335,539,672 out of their total net income of $9,394,398,417. Their income from dividends was 3.6 per cent of their total net income. These dividends were paid out of corporate net income taxed at 10 per cent. The tax paid by the corporations with respect to these dividends was $37,282,186. If the corporations had not been taxed on their income and the dividends (not reduced by the income tax on the corporations) had been taxable to the individuals, the tax would have been not more than $14,912,874 (4 per cent of $372,821,858). Actually it would have been considerably less, on ac-

count of the credits of those whose income from other sources was not equal to the credits to which they were entitled. But disregarding entirely the matter of credits, we note a difference of $22,369,312.

This represents the minimum figure of the amount of the injustice done through denial of the 4 per cent normal rate. It is not, perhaps, in the tax language to which we are becoming accustomed, a large amount. Still even the sum of $22,000,000, wrongly taken, is not to be lightly brushed aside, particularly when it is remembered that it falls upon the class of taxpayers least able to bear it. These $22,000,000 were taken from a class of taxpayers numbering 3,946,152. But it must not be hastily assumed that the average of less than six dollars ($5.67) represents the average of the injustice done. The amount thus unfairly taken from this class of taxpayers was not, of course, pro-rated among them. Very many, probably the great majority, of these persons had no income from dividends. The injustice was done, therefore to a much smaller number of persons than 3,946,152, and the average thus taken must have been a distinctly material sum, while the injustice done in individual cases of persons living on small incomes wholly or mainly in the form of dividends was really serious and, I believe, indefensible.

The foregoing calculation has been confined to the taxpayers having incomes not in excess of $5000. The injustice is by no means so confined. For example, 319,356 persons in the $5,000-$10,000 class received, in 1918, $326,000,000 in dividends, being 13 per cent of their income. Many of these persons were undoubtedly denied a part of the advantage of the 4 per cent normal rate on the first $4000 of income above the statutory credits. It is not possible to calculate the amount of this injustice. But it is safe to say that the injustice done here must add very materially to that which has been calculated for the lower income classes. The aggregate result is too serious a matter to be regarded lightly.

The remedy is perfectly simple: give up the income tax on corporations and include dividends in the incomes of individuals for the normal tax as well as the surtaxes. This does away entirely with the injustice. It assures to each individual the credits to which he is entitled and the advantage of the lower normal rate so far as he is entitled to it.

This proposition has other advantages. May I quote the following paragraph from my article in the December Review:

> This proposition has many other advantages, of which space permits only the mention. It makes the income tax a strictly personal tax. It does away with the false idea of tax-free investments. The taxpayer knows he is taxed. This is good for the taxpayer. It is also good for the state of public opinion, since it removes the public irritation caused by the spectacle of large classes of income exempt (supposedly) from taxation. It brings home

to the individual his direct interest in economy of government expenditure and his responsibility for the conduct of government finances. The same arguments apply, of course, to the taxation of interest on bonds. The mistakes already made as to the tax-free covenant should be avoided in future.

Again this change would make corporate stocks a more attractive investment for persons of modest incomes and for estates and trusts held in the interest of such persons. Relief from the income tax would ultimately enable corporations to pay higher dividends, which in the hands of the stockholder would enjoy the benefit of the personal exemption.

It is not the purpose of this essay to examine current plans for a general overhauling of the federal revenue system. But it is necessary to recognize the fact that if the excess profits tax should be repealed (as now seems to be quite commonly assumed), the proposition to give up the corporate income tax would have to be accompanied by some tax upon the undistributed income of corporations. Otherwise owners of incorporated businesses would have an unwarranted advantage over partnerships and sole proprietors, since the latter are taxable, under the individual income tax, upon all their earnings, whether distributed or not.

It is true that equality might be obtained in the opposite way: *i.e.*, by exempting the undistributed income of partnerships and individuals. I must confess to a strong leaning toward such an arrangement, on the principle that earnings left in the business are really not income and should, in theory at least, not be subject to an income tax. This is a topic which I should have liked to discuss in this essay had time permitted. However, as a practical proposition, the exemption of undistributed earnings of partnerships and individuals is not likely to be seriously considered in the forthcoming tax revision. In case of the repeal of the excess profits tax, therefore, the proposition to give up the corporate income tax must include a tax upon the undistributed income of corporations.

The fundamental principles of such a tax are developed in my article in the December Review to which I have already had to refer. To summarize briefly here:

The purpose of the tax on corporate undistributed income should be to equalize between corporate investors and partnerships and individuals, and to prevent deferring dividends for the sake of avoiding taxation; its purpose should not be to force distribution or to penalize the putting of earnings back into the business.

The rate of the tax on undistributed income may be determined in various ways. A flat rate on all such earnings would be the simplest. The plan which I have favored consists of a double progression, based upon (1) the amount of the corporation's invested capital, and (2) the ratio of undistributed earnings to capital, the rates ranging from say,

10 per cent, the lowest, to a maximum of 50 per cent. The following scheme of rates is offered as a suggestion:

Invested capital	Ratio of undistributed earnings to invested capital (%)				
	Over — Not over 10	10 30	30 50	50 75	75 —
Not in excess of $100,000	10	15	20	25	30
Over $100,000 and not over $1,000,000	10	20	30	40	50
Over $1,000,000 and not over $10,000,000	10	25	40	50	50
Over $10,000,000...	10	30	50	50	50

In order to avoid injustice to the small close or family corporation, a small fixed amount of undistributed income, say the first $5000, should be taxable at a lower rate, i.e., the lowest or normal rate of the individual income tax. Or, as an alternative to this, the law might permit any corporation to elect to be treated like a partnership. This would require simply the calculation of each stockholder's distributive share of the corporation's net income, which share (whether distributed or not) would then be taxed to the stockholder as personal income. The corporation would be untaxed. This option, when accepted, would give absolute equality between such stockholders and individuals and partners.

I realize that objection will at once be raised to this scheme of progressive rates on undistributed income, on the ground that it would perpetuate the determination of "invested capital," generally considered one of the most troublesome features of the excss profits tax. May I, in answer, quote again briefly from my REVIEW article:

> That the legal determination of invested capital is complicated and annoying cannot be denied. That it should now be given up is not so certain. The worst stage has been passed. Putting the new device into operation, in the midst of the disturbances incident to war, was a tremendous task. Continuing its operation in time of peace is a matter of less and steadily diminishing difficulty. It is at least open to question whether the progress already made should now be given up. If the most equitable taxation of corporations should seem to require the determination of invested capital, it is reasonable to suggest that the advantage gained may fully compensate for the admitted objections on the administrative side.

The next few months will almost certainly witness important changes in the federal revenue system. It is to be hoped that these changes may establish as the foundation of the American revenue system an improved income tax, based upon sound economic principles as regards the nature of taxable income and the essentially personal character of the income tax.